DOW THEORY LETTERS INC.

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36 Letters per Year – $95 Annually

Registered with the Securities Exchange Commission

December 21, 1973 Letter 584

Dec. 7, DJIA 838.05; PTI 641; A-D ratio -19.52
Dec. 14, DJIA 815.65; PTI 625; A-D ratio -20.45

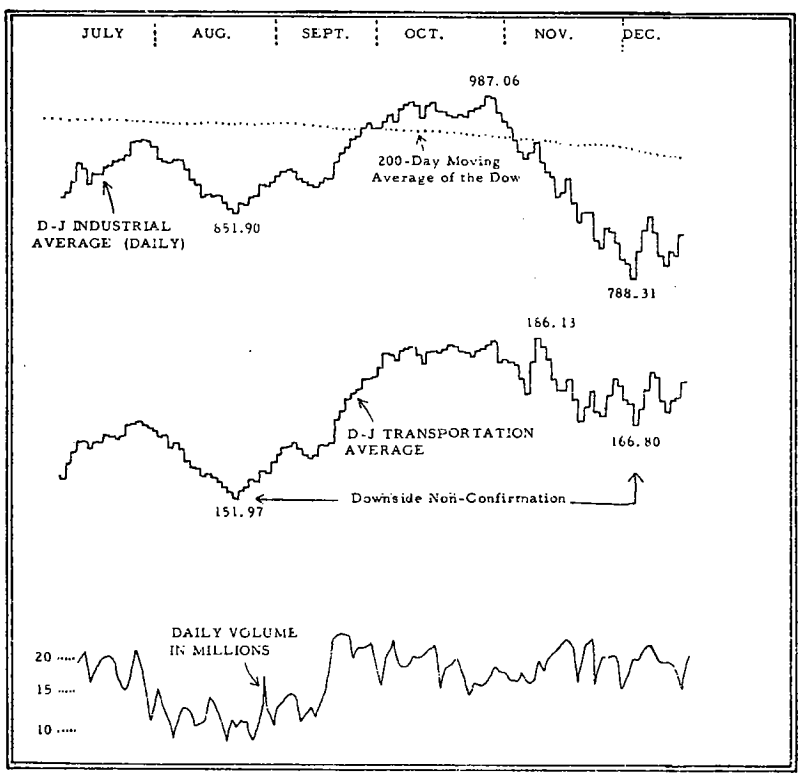
LEAD-OFF "FOOTNOTE": From its July, 1973, all-time high of $127, gold bullion corrected to a November, 1973, low of $90. At that time (Letter 581) I stated that I believed the correction in gold was over. The total correction amounted to $37. The halfway or 50% level of the entire correction was $108.50. On December 18 the second London gold fixing was $109, or above the 50% level. According to my studies of the "50% Principle," gold should now work its way to and probably well above the $127 all-time high. I trust that all my subscribers will have purchased their gold shares this side of $127 gold (see later section).

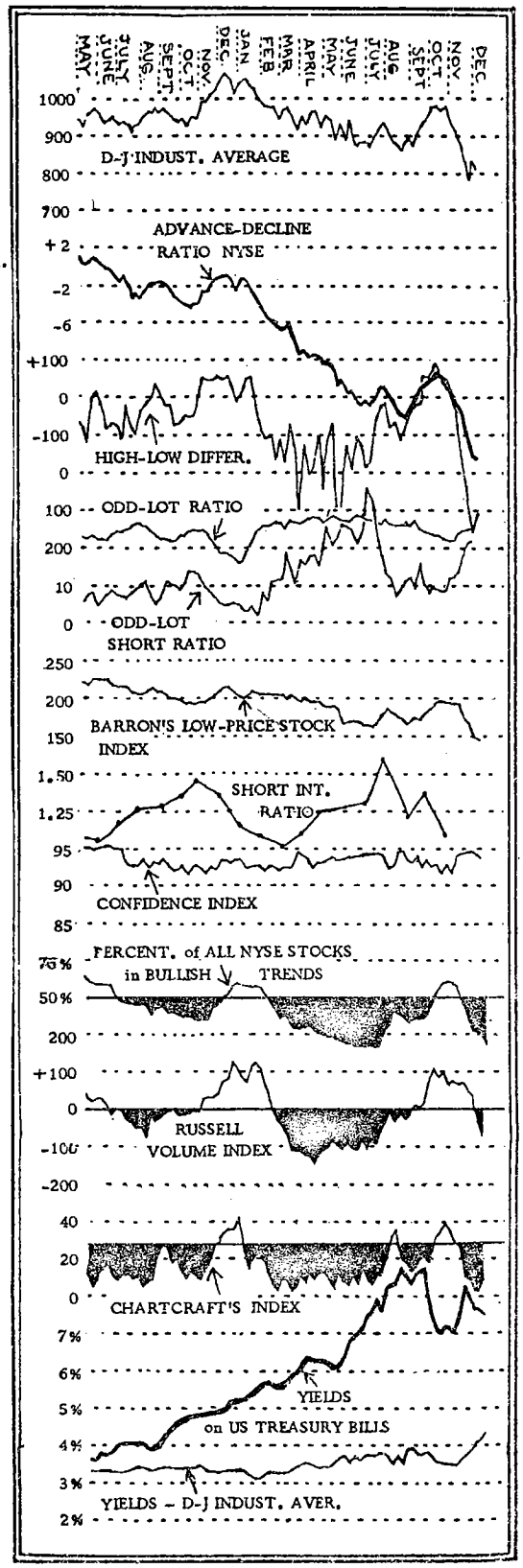
THE MARKET: I don't want to spend too much time on the current (daily) price action. The stock market (like a prize fighter who has hit the deck five times in a single round) is clearing its eyes and rising to its feet. My weekly high-low plurality index (see Letter 582) hit minus 996 on the week ending December 7, not enough for a really important bottom, but enough to give us a decent rally into 1974.

I drew attention in the last two mailings to the fact that the Transports did not confirm the Industrials on the downside. In fact, the carriers have stubbornly resisted moving anywhere near their August low of 151.97 (see chart). The Transport action has thus been setting the stage (from the Dow Theory standpoint) for a technical rally, and the rally now appears to be well on its way.

So far, despite strength in the Dow Averages, the "lifting power" of this market has not been impressive. As late as December 13 the advance-decline ratio recorded another primary bear market low. On December 17 the Primary Trend Index (PTI) touched a new bear market low of its own. I see the action of both these indicators as suggestive of long-term technical weakness, but over the intermediate-term the market appears ready to follow the seasonal or "end-of-the-year" rallying pattern.

I noted in the last Letter that we had about reached the point where the Averages





would start rising in anticipation of the ultimate lifting of the oil embargo. I suspect that we are in that phase now. When the actual news hits the headlines, I believe informed investors will sell and sell heavily. I would guess that the next downward leg for the bear market will be timed to the actual "good news" on the oil front. Remember, the market's function is to discount news, not to act on it. The settlement with the Arabs is no longer a matter of "whether," it is a question of "when."

Bear markets often record their annual highs during the first quarter of the year (January is a favorite month). This is because Christmas enthusiasm seems to lift the bear market merrily into the new year, but then the sobering facts of life take over, and the top is formed. With the massive "oversold" condition of this market it is obviously impossible to foresee how far a rally could carry. I would not be surprised to see a January or February top, but they don't design Wall Street price movements for Richard Russell's benefit, so I'll state again that it is easier to identify the next top than to forecast it.

The damage to the 1973 market has been breathtaking in its severity, and we might remember that the character of bear market rallies often bears a relationship to the character of the preceding smash. My astute friend, Martin Zweig (Professor Zweig if you are a student at New York University) has provided statistics in his latest Zweig Report which show just how bad the recent bear market action was. Marty writes: "Since our ...averages peaked on March 9, 1972 ... the average NYSE stocks have lost a sickening 45.6% and the average Amex issue an unbelievable 59.9%!" The Professor further states that his NYSE index "is now 14.4% below its July 7, 1970, low! In other words, in 3½ years since the absolute bottom of the worst market break in 33 years, the average stock has managed to go lower again, by a large margin to boot." (Written Dec. 14).

In view of these statistics, it seems incredible that I have had to write, repeat and insist that this is a continuing primary bear market. I doubtlessly will have to do it again and again. But I might remind subscribers that over the past few years those who have preferred to hold stock certificates and wear rose-colored glasses are a good deal slimmer in the assets sector. Yet all is not lost — perhaps they have at least gained some respect for Dow's Theory and the ultimate power of the primary trend.

THE PICTURE: In order to understand the investment (and survival) policy which I have been advocating for my subscribers, it is absolutely necessary to comprehend the psychology of bull and bear markets. Primary bull and bear markets can almost always be divided into three recognizable psychological phases (not to be confused with price movements).

I'll start with primary bull markets. The first phase of a bull market represents the initial rebound from the depressed levels of the preceding bear market bottom. We can call this the climb from "liquidation levels" to the area of known values. It is well to note that only highly informed investors do the buying in the first phase.

The second bull market phase is characterized by an advance in which stocks reflect obviously improving business conditions. But skepticism during the second phase is still widespread. Although this rise is broader-based than the first phase rise, it is nevertheless the informed investors who are doing most of the buying in the second phase. The second phase (and this is important) is (1) usually the longest phase, (2) the most deceptive phase and (3) the phase which is marked by severe secondary reactions. Despite rising market prices, stocks can be considered "values" throughout the second phase.

The third or final phase of a bull market is unique in that here we see the entrance of the public, "the crowd" with its money in its sweating hands. They have resisted the first and second phases; they are to resist no longer. In the third phase speculation and high volume are the order of the day, and in this phase many (if not most) stocks careen far above known values. It is during the third phase that the low-priced stocks (the "cats-and-dogs") traditionally make their major moves skyward. It is also in the third phase that the early buyers (the informed investors) start distributing their wares. And of course they have a perfect climate to do so since the third phase is characterized by big volume and emotional rises by most stocks in response to rumors, tips, news items, bullish statements — and a generally rosy atmosphere.

Just as a bull market has three psychological phases, so a primary bear market has three phases. The first phase represents the drop for the preceding bull market top, a drop which appears to be "unexpected" and which serves to erase much of the froth and frenzy of the preceding bull market's third phase top. As a matter of interest, the first phase of the current bear market occurred during 1966. The second phase of a bear market (as with a bull market) is generally the longest, and again is marked by deceptiveness, confusion and many violent (upward) corrections. In the second bear phase stocks go down in response to obviously deteriorating business conditions. During the first and much of the second bear phases, the selling comes from the portfolios of informed investors. In reference to the current bear market, the second phase began in 1967, and by my reckoning we are now deep into the latter part of the second phase. This is the area in which stocks suddenly collapse as the business climate turns from "scattered clouds" to "gray and overcast."

The third phase of a bear market represents the final liquidation phase. It is here, said Robert Rhea (the great Dow Theorist) that "Those who have been holding stocks for a rainy day wake up to find that it is raining." In the third phase good stocks are sold because there is no market for the bad. This is the period where money (regardless of sacrifice) must be raised. The third phase is usually characterized by a long, low volume slide to levels which are below anything the analysts can account for (in other words, stocks sink below "known value").

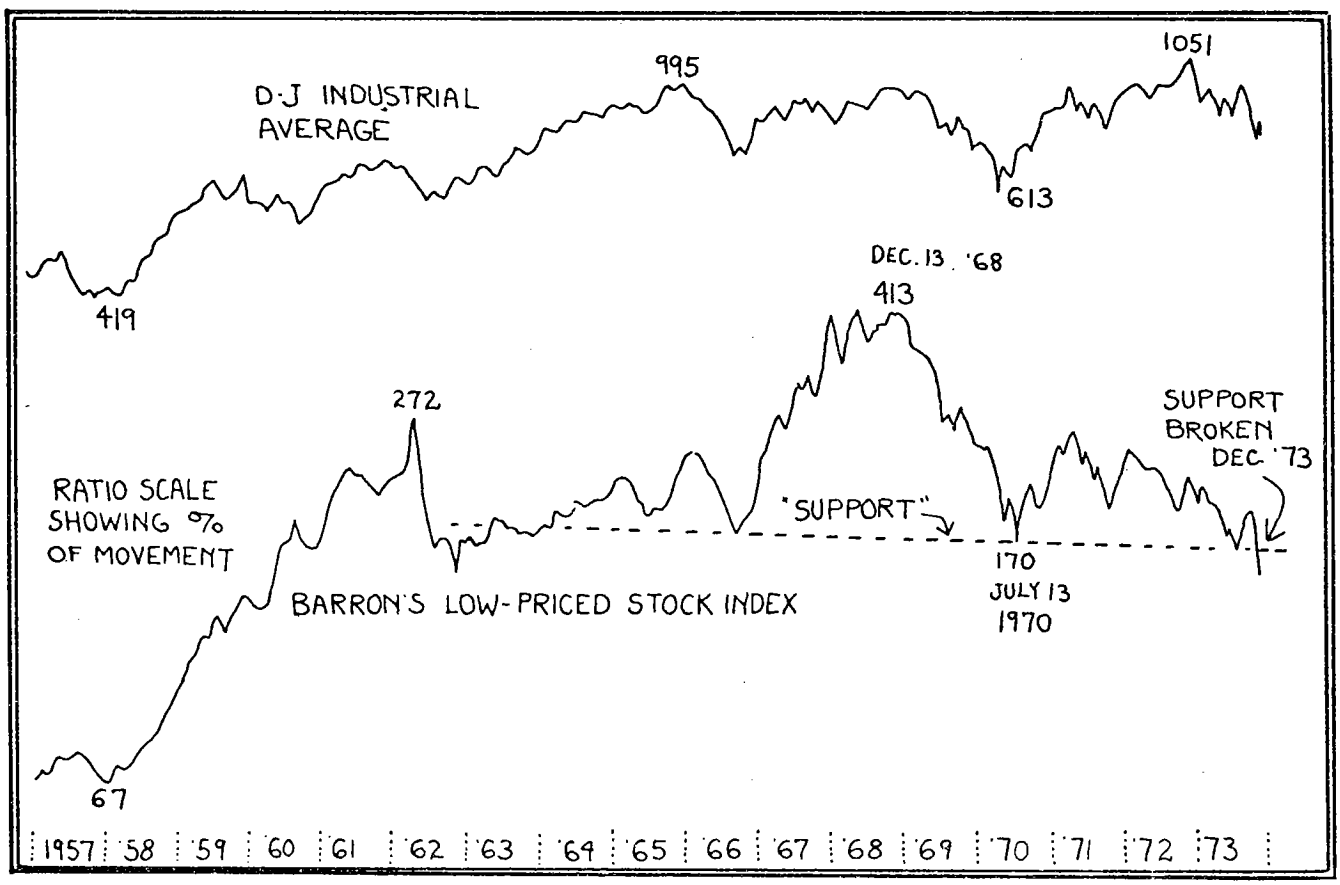
As veteran subscribers know, it has long been my contention that just as the primary trend of stocks and economies the world over are in a major bear market, the primary trend of gold and gold stocks alone has been in a primary bull market. The bear market in common stocks is visible enough — the markets not only of the US but the entire world are in tatters (see page 6 chart).

I will assume that my subscribers have read these reports and are out of stocks, and this casts us in the role of interested and sympathetic observers. Obviously, those of us who run businesses cannot stand aloof, however, for even though we are out of common stocks, this bear market is presenting increasing business problems. But it is better to expect trouble and be prepared for it than to be caught with our "financial pants" at half mast. Therefore, I hope none of my subscribers have been surprised by the events of 1973, or at least by stock market events.

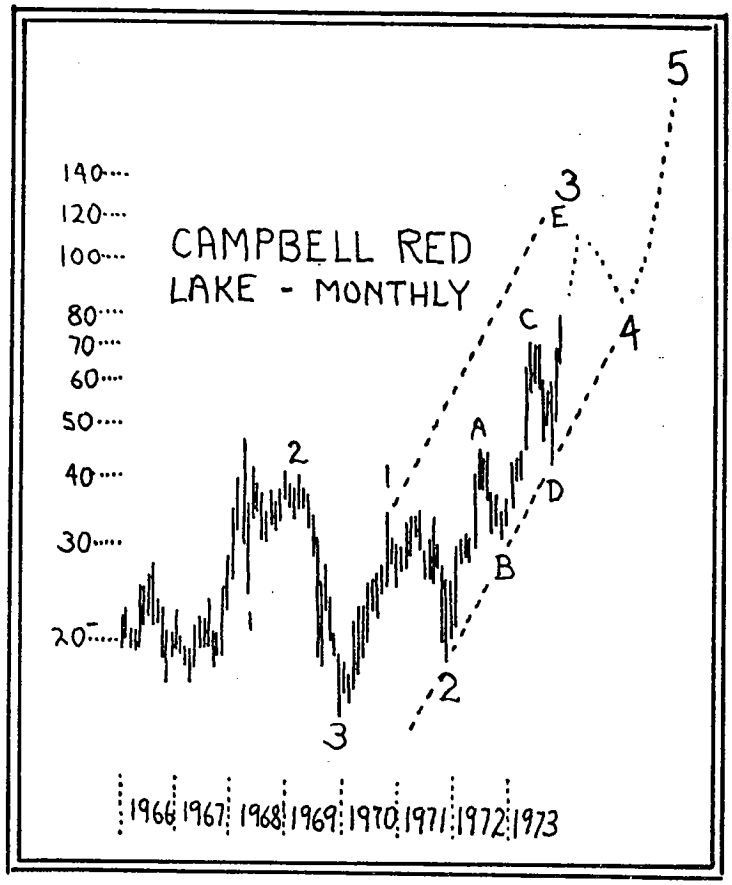
Fortunately, the powers-that-be seem to have provided an island of reprieve for us, a time-honored financial "life preserver." That island is the gold stocks, the stocks of a group which has been castigated, denounced, trod upon, and sneered at by official Washington for a quarter of a century. Ironically, despite the US's efforts to get out from under the discipline of gold, the yellow metal and the gold stocks have been the only real port in this storm.

So far, I have placed primary emphasis on purchasing the top gold shares, the big mines of Canada, South Africa plus Homestake in the US. Now I want to go into a special and little understood phenomenon, the movements of the low-priced stocks or "cats-and-dogs." In order to understand the next section, it will be necessary for me to write not just about low-priced gold shares — but low priced stocks in general. For the L-P shares are a special phenomenon in the stock market; they inhabit a world of their own, and they are subject to movements and a psychology all their own. Therefore, let's talk about the anatomy of the L-P stock, whether it be a $1 department store, a 50¢ mining stock (the L-P mining issues are often called "penny stocks") or a $1.25 hotel chain.

First of all, L-P shares (of whatever "species") generally lay "dormant" during the first and second phases of a bull market. They make their major upward moves only during the third phase of a bull market (spurred on by crowd buying). And when the L-P issues rise, they don't just go up, they tend to rocket up to fantastic "spearpoint tops." These tops are often 300% or 500% or more above the first phase starting point. And once having topped out in the third speculative phase of a bull market, the L-P shares turn down, often collapsing as violently as they advanced. Once returning to earth, the L-P stocks lay dormant again for years and years.



All of which brings us to the chart shown on page 3. Here we see the Dow Industrials along with an excellent gauge of L-P stock price movement, Barron's Low Priced Stock Index (both drawn to ratio scale showing percentage of advance or decline). From the 1968 all-time high of 413, Barron's L-P Index dropped to last week's 16 year low (!) of 148. In doing so the L-P Index has erased almost two-thirds of its peak value. I am afraid, however, that there may be a good deal of agony still ahead for the L-P issues. For note that the formation of the L-P Index has assumed the pattern of a huge "head-and-shoulders" top. This top (since it is so massive) could easily take the L-P issues down to the 40 to 80 area, or to the general vicinity in which they started their rises back in 1949.



Now for the other side of the coin. I have also pictured here a semi-logarithmic (ratio scale) monthly chart of Campbell Red Lake Mines, the leading Canadian gold producer. Here is the way I analyze the movements. A huge correction occurred in golds during 1968-70, taking Campbell (CRK) down from 47 to 14.5. The correction assumed the form of a typical 1-2-3 Elliot decline, as shown on the chart. From there the current bull market in golds began.

The first upward wave in CRK's bull market is labeled 1 on the chart; it carried from the 1969 low of 14.5 to the 1971 high of 35. This marked the first phase of the gold bull market, the phase in which informed investors took their initial positions. Following the 1971 peak, we witnessed the first bull market correction, which is labeled wave 2 (ending at the late-1971 low of 18.5).

The second psychological phase of the bull market in golds started from the 1971 lows. From here, gold shares began moving up in response to subtle but gradually bettering news on the gold front. Yet it was still the investors, not the public, who were buying the golds. The current second bull phase should be the longest "up phase" and I have drawn it on the chart to show an A-B-C-D-E Elliot pattern with the D to E leg not yet completed. The D-E leg could "extend," meaning that this leg could break up again into another A-B-C-D-E leg within the E leg. Then we should have the second major correction as shown, the correction labeled leg 4.

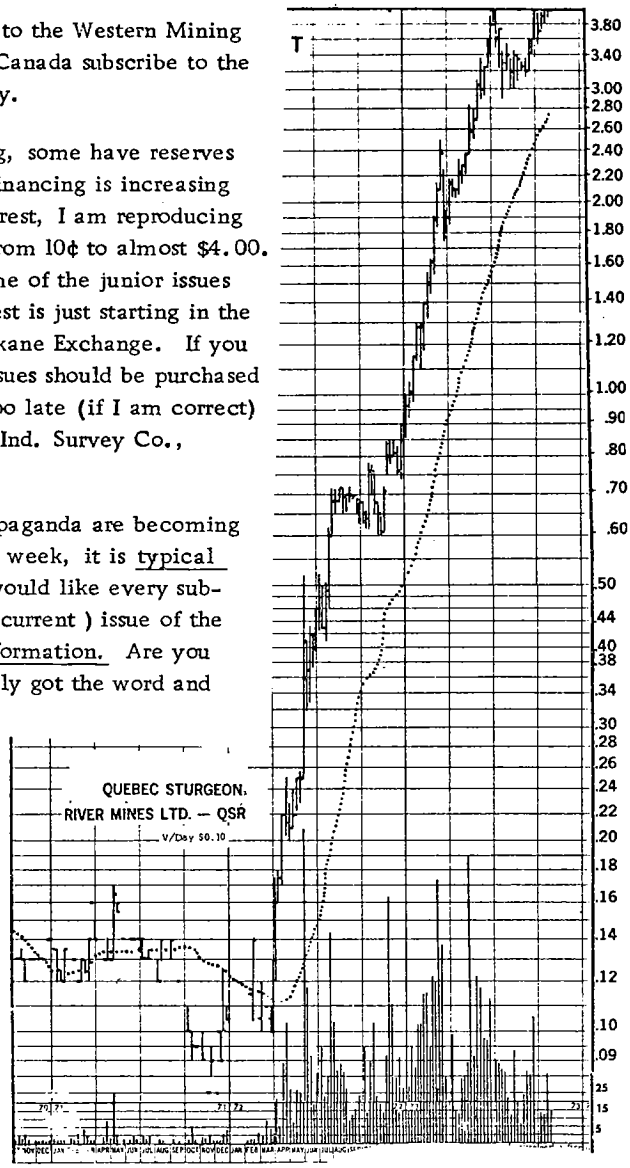
Finally, we will go into the third phase of the gold bull market. And this is what I want to talk about — the phase in which the penny gold stocks should make their major upward moves. And those moves could just be the eye-openers of the whole gold story. But remember, the low-priced gold shares are risky affairs, they are highly speculative, some will make it and some won't. Penny gold shares should be bought only with "spare money," money you are willing to "write off" if the situations don't work out. But there will be profits if my third phase analysis of the gold picture is correct, huge profits of perhaps 500% to 2000% in some issues.

If you want to play the final gold phase (and remember, all this is theoretical; it doesn't have to happen the way I think it will happen), the best way is diversification. Pick five or preferably 10 low-priced issues here in this low area, put them away, write them off, and forget about them. There are two main markets for the low-price gold shares, the Canadian market and the Spokane Exchange in Washington. I am not going to run a "tip sheet" on what "stocks to make a fortune on." Everything here is probability. But I do think that before the bull market in golds is over, the public is going to come in big, and when they do they will want to buy alot of shares for their money. Well, they can't buy ASA or Dome, but they can buy the "penny issues, the "junior mines," and that is just where the public is liable to go.

I am going to list some of the low-priced gold issues, but remember, this is only for your study. Show the list to your broker, make him work, make him dig up the facts, get his opinion (he's not going to do much business if he doesn't know the gold picture anyway, so a little gold research may just keep his job for him over the next few years). First I will list a few representative Canadian junior gold shares: Royal Agassiz, Kiena, East Malartic, Quebec Sturgeon, Agnico-Eagle, Goldex, Mentor, Hydra Exploration, Wright-Hargreaves and Lake Shore Mines (the last two are also listed on the Amex and are gold mine holding companies rather than mines). On Spokane we have Little Squaw, Judith Gold, Golden Eagle, Gold Placer, Bonanza Gold.

For Spokane, I suggest (if you are interested in these golds) subscribing to the Western Mining News, Box 8237, Manito Sta., Spokane WA 99203, $6 annually. For Canada subscribe to the Northern Miner, 77 River St., Toronto, Canada M5A 3P2, $15 annually.

Remember, these are all highly speculative stocks, some are producing, some have reserves but no financing as yet, some are just being financed (and interest in financing is increasing enormously now, due to the rise in the gold price). As a matter of interest, I am reproducing a chart of Quebec Sturgeon, a gold issue which has climbed this year from 10¢ to almost $4.00. I am showing this chart simply to illustrate what "could happen" to some of the junior issues (and it did happen to Quebec Sturgeon). In my opinion, general interest is just starting in the Canadian junior gold shares, and it has hardly started at all on the Spokane Exchange. If you are interested at all in the low-priced end of the gold picture, those issues should be purchased in this area, before the public comes into the gold scene. It will be too late (if I am correct) once the public takes the bit in its mouth (chart of Quebec courtesy of Ind. Survey Co., PO Box 6000, Vancouver, B.C., Canada V6B 4B9).



As an aside, the signs of a gradual but steady turn in the anti-gold propaganda are becoming unmistakable. I reproduce here a UP press release which appeared last week, it is typical of many "gold stories" now beginning to appear in the newspapers. I would like every subscriber to read the extraordinary lead-off story on Gold in the January (current) issue of the National Geographic magazine. This article is a storehouse of gold information. Are you ready for this one? OK, "The Thundering Herd" (Merrill, Lynch) finally got the word and they have just released a 12 page special study entitled "Gold." Get it if you can, it's well worth reading and it's from the world's largest brokerage house. From the (bullish) final Merrill, Lynch conclusion: "...many nations and individuals will probably continue to regard gold as their ultimate strategic reserve, particularly the oil rich countries of the Middle East. The effect of a falling supply and strong demand suggests an exciting future for gold."

But don't let these articles fool you. The public and most investors have not even begun to get on the gold wagon — yet. I fully believe that gold shares are still a buy. When the public does climb aboard, you won't have to ask me for the "signs" — you'll see them as well as I will.

PEOPLE:

Despite all the headaches that go along with monetary crises, some people find that they bring pleasant fringe benefits. The important thing to remember. U.S. Under Secretary of the Treasury **Paul A. Volcker** told a group of cabinet wives Thursday, is that they can lead to hurried jaunts to exotic places.

"Every monetary crisis generates a trip," Volcker said in an introduction to a short discussion of monetary reform. "We spent last weekend at this nice little château in France," he said, referring to a weekend meeting outside Tours by monetary officials from the United States, Britain, France, West Germany and Japan.

"We spend a fair amount of time in places ranging from Rome to the Smithsonian Institution in Washington. You talk about it being a great crisis, but there is a certain amount of comfort involved."

A TRIP: Crises aren't all bad. A New Zealand subscriber sends me this clipping from the November 30 Paris edition of the International Herald Tribune (you'll have to admit that subscribers to these Letters get around!). I thought the clipping was worth publishing — after all, it's good to know that this nation is not sitting on its hands in the face of the world monetary turmoil.

INTERNATIONAL: Speaking of turmoil, I include on page 6 my chart of 9 major stock indices, all drawn to ratio scale so that percentage of advance or decline can be correctly compared throughout. On December 19, Japan broke the 4000 level while Britain continued to plunge toward 300 even. This "international profile" is not a pretty sight, but it's something we should be fully aware of.

I thought the following from First Nat. City Bank's International Report, goes a long way toward showing what is happening in international markets. Next step could be competitive devaluations. But the big picture is a weakening of all paper currencies against gold.

'Gold Fever' Breaks Out Over Idaho

IDAHO CITY, Idaho (UPI) — Prospecting is sweeping Idaho and reviving interest in long-deserted gold fields.

"The price of gold has proliferated interest and activities all over the state," said W.R. Bondurant, technical aide for the Idaho inspector of mines. "We often see one or two men out panning but whether they are getting anything or not, we don't know."

"Devaluations usually trigger a certain number of standard reactions — and one of them is a gradual decrease in imports' share of domestic markets in the country that devalues. This reaction now seems to be occurring in the United States. So far, volume of imports has declined because the dollar devaluations have raised import prices; for a time, the price rise will have increased the import bill more than the decline in volume has decreased it; but eventually, as the volume falls further, the import bill can hardly help dwindling.

"Foreign goods are also getting priced out of the US market, because foreign inflation has been worse than the US variety in recent years. And finally a developing US slowdown is affecting demand for imports more than total demand."

CHRISTMAS: It is considered fashionable (and safe) these days to wish everyone Season's Greetings, instead of Merry Christmas, because the latter may "offend" Jewish clients. To which I say bunk. I have readers of every color and denomination in every corner of the world. And although I am a Jew myself, I want to wish them all a Merry Christmas.

Many Jews take pride in their belief that in Freud they produced the first great psychologist. Jesus (a reform rabbi if you are Jewish, the son of God if you are Christian) was also a great psychologist — as may be gathered from these sentences from the extraordinary "Gospel According to Thomas."

"Jesus said: Let him who seeks, not cease seeking until he finds, and when he finds, he will be troubled, and when he has been troubled, he will marvel, and will reign over the All. Jesus said: If those who lead you say to you, 'See, the Kingdom is in heaven,' then the birds of heaven will precede you; If they say to you, 'It is in the sea,' then the fish will precede you. If you will know yourself, then you will be known and will know that you are the sons of the Living Father. But if you do not know yourself, then you are in poverty and you are poverty."

* * * *

The next mailing will be on January 4, which means I am taking a few extra days between this Letter and Letter 585.

Perpetual motion is a reality — it exists, and it exists in the form of my friend, Harry Schultz. I have just received a copy of his new book, "Financial Tactics and Terms for the Sophisticated Investor." I'm not too sophisticated, but I took a chance and read the book anyway. It's outstanding, a mass of knowledge, theory, practical material, addresses (not Harry's girlfriends, of course), how-to-do-it and where-to-do-it investment data. In a phrase, I recommend it. In fact, I wish I had had the brains and energy to have written it myself. (Harper & Row, $7.95, hard-cover).

LATE NOTES: Golds are strong to very strong on any market weakness. It is obvious that fund money is now going into them. My "antenna" tells me the big money is now going into Vaal Reefs, West Driefontein and Western Deep Levels, and subscribers who have not moved might do the same. On Dec. 18 ADR volume in the golds hit a five month high. I include charts here of three of the big listed NYSE gold shares, and the charts speak for themselves. These charts are courtesy of Quote Digest, Box 213, Wichita, KS 67201.

LATE, LATE NOTE: I must say that even I am surprised at how sloppy the market breadth looks on this rally — I don't know if this thing's going to make it into January . . .